Disruptions to hit M&A, financing

Chemical industry senior executives aim to assess and navigate through a growing list of disruptions. This will impact M&A and financing markets well into 2023

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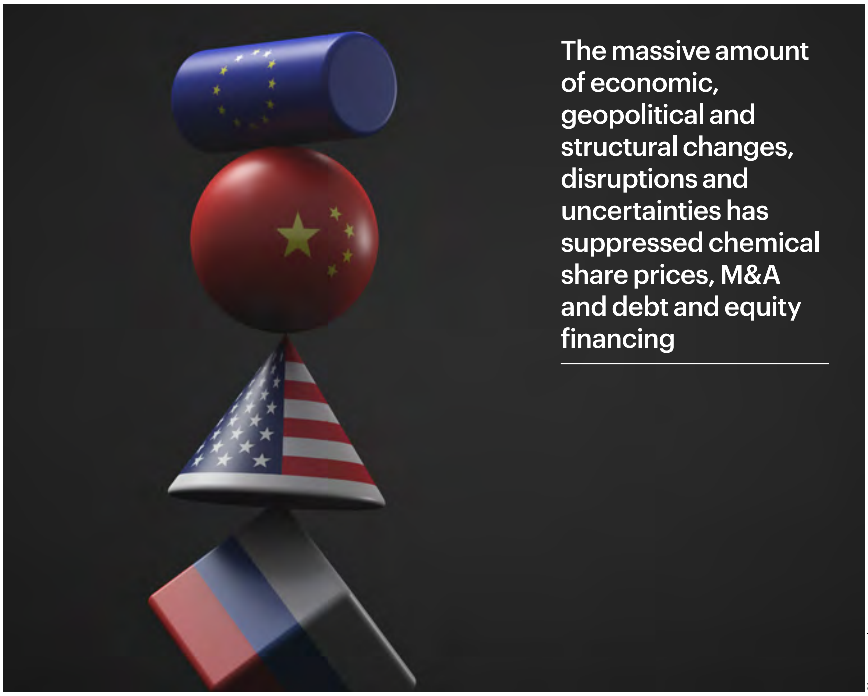

The massive amount of economic, geopolitical and structural changes, disruptions and uncertainties has suppressed chemical share prices, M&A and debt and equity financing

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The list of challenging disruptions and structural changes continues to be long, but some are now more menacing. We are facing serious economic changes (inflation, the potential for a recession globally, volatile oil and energy prices, higher interest rates, the ongoing impact of COVID-19), geopolitical challenges (rising tensions with China, the Russian invasion of Ukraine and the resulting the impact on energy prices and availability of many commodity and food products), regulatory pressures (net zero carbon, green chemistry) and structural problems (shift to electronic vehicles, long-term supply chain issues, shortages of semiconductors, and shortages and higher cost of labour).

These were all topics discussed during the Young & Partners 35th Annual Senior Chemical Executive Conference in New York where speakers and panels focused on "Strategic Management in a Period of Disruptions" and the impact these disruptions on financial markets and the mergers and acquisitions (M&A) options available to industry leaders.

The most troubling is the deteriorating economic outlook – particularly in Europe and emerging market countries, including China. There are many factors that are holding down economic growth in China, with the negative effects of the zero-COVID policy becoming increasingly prominent. The US economic outlook includes the possibility of a recession, but any recession is expected to be mild.

The impact on chemical companies has become more severe with demand dropping globally and cost pressures continuing to be high. As a result, profits have weakened.

Attempts to comply with ESG (environmental, social, governance) trends are forcing chemical companies to divert cash flows towards the necessary capital expenditures. Of course, the impact of economic and geopolitical events will vary by company depending on the markets they serve, supply chain configurations, their ability to raise prices, and their dependence on oil and gas and geographic locations.

Equity and debt markets take hit

Overall stock market prices were down considerably by the end of the third quarter. The S&P 500 decreased by 25.2% and the S&P Euro 350 by 20.8%. Although there has been some upward movement recently, prices are still down and the outlook is uncertain. Six of the seven Young & Partners chemical stock price indices were down anywhere from 20.7% to 36.9%. Only the fertilizer index was positive. As a result, the valuations of commodity and diversified chemical companies have come down considerably.

We are going through a market correction in 2022 that may or may not be longer term in duration. Since a great deal of the correction has been driven by interest rate increases and economic concerns, weakness may last for some time.

Senior managements of chemical companies should assume that equity prices will remain suppressed or subdued until there are clear signs of an economic recovery and/or until inflation and interest rates moderate. There are a large number of chemical companies that are structurally undervalued, presenting a challenge for the CEOs of those firms.

On the debt side, interest rates have gone up considerably and lenders are hesitant to extend loans, particularly for leveraged buyouts (LBOs), due to concerns about lender risks and the overhang of leveraged loans they have not been able to place with institutional investors.

Global non-bank debt financing was only $26bn in the first three quarters of 2022, compared to $51.3bn for all of 2021. High yield debt issuance was almost nonexistent. Debt issuance will continue to be lower in the future given higher and increasing interest rates, the unwillingness of lenders to lend, and slower M&A activity. The combination of higher interest rates and falling public valuations has driven up the cost of capital for chemical companies.

Slowdown in M&A with a caveat

Based on our detailed data analysis through the first three quarters of 2022, there was a dramatic slowdown in M&A in the first quarter (only 13 deals totaling \$10.4bn), a surge in the number of deals but a lower dollar volume in the second quarter (29 deals totaling \$8.3bn), and a drop in the number of deals but a jump in dollar volume in the third quarter (22 deals totaling \$13.6bn).

The total through the first three quarters add up to 64 deals totaling \$32.3bn. Annualised, this is well off the 85 deals totaling \$72.8bn for all of 2021.

Although there has been volatility across the quarters in 2022, the overall conclusion is that the number of deals appears to be flat and the dollar volume has fallen – so the average deal size has fallen considerably. Discretionary deals are not getting done, strategically important deals are still going through.

If you look at the trends below the totals, there are a number of important shifts. First of all, although it is hard to believe, 57.3% of all deals occurred in Asia (up from 37.7% last year) and principally in China. That means that even though the global number of deals completed are on a pace that is flat compared to last year, the number outside of Asia has fallen considerably.

In summary, unless you are an active buyer or seller of Asian chemical businesses, the relevant market activity shrank this year.

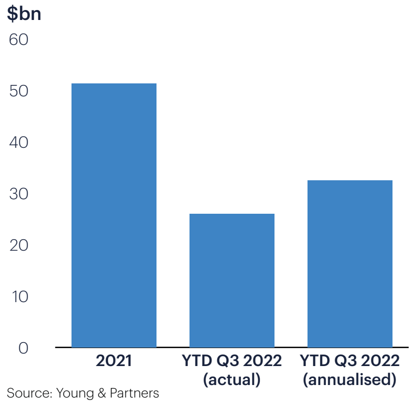
A major portion of the drop in Western M&A deals was seen in Europe. Concerns about the European economic outlook, including the supply of natural gas and oil, has suppressed interest in European chemical M&A.

The number and share of commodity chemical deals has fallen with higher uncertainty surrounding the future profitability of commodity products. Valuations also fell dramatically for commodity chemical deals from 12.1x EV/EBITDA (enterprise value/earnings before interest, tax, depreciation and amortisation) last year to 7.0x EV/EBITDA year-to-date through Q3 2022 as the balance between supply and demand shifted heavily in favor of buyers.

Specialty chemical M&A multiples are still high, but are slowly coming down. In the first three quarters, the average was 12.2x EV/EBITDA, compared to 12.9x last year and 13.9x the year before. Buyer demand still is stronger than the supply of businesses to buy.

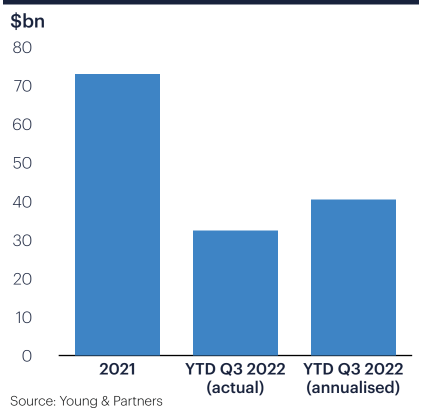
What is our prediction for Chemical M&A for the rest of 2022 and beyond? Strategic divestitures and acquisitions will continue and

Global chemical non-bank debt financing



Source: Young & Partners

Global chemical M&A – equity value



Source: Young & Partners

The key will be the ability to be resilient, to pivot quickly as conditions change, and to focus on maintaining and building competitive advantages

drive at least a moderate level of M&A activity at least through 2023. M&A activity will be focused on divestitures of non-core businesses, acquisitions and divestitures driven by the desire by certain companies to shift their overall themes, and the divestitures of private equity owned businesses.

Overall, the number of deals this year will match last year's total and the dollar volume will be healthy, but will likely fall short of last year's total. We are clearly in a suppressed M&A environment that will continue for some period of time.

Equity offering volume falls

In a falling stock market environment, it is not surprising that overall chemical industry equity financing volume fell in the first three quarters. The drop in valuations contributed to a slower pace of chemical equity issuance as was true for the general equity market.

\$14.9bn of equity was issued via 68 offerings in the first three quarters of 2022. Annualised, this was a serious drop in activity compared to the \$22.3bn of equity issued via 116 offerings in 2021.

IPOs (initial public offerings), on the other hand, did not slow as much with 37 IPOs completed worth \$9.2bn in the first three quarters of 2022 compared to 58 IPOs completed in 2021 worth \$11.2bn.

However, Asian companies issuing in Asian public markets continued their domination of both the IPO and secondary offering markets, which has been true for many years.

Looking forward, chemical equity issuance and IPO activity will be soft for the rest of 2022 and in 2023 due to overall market conditions. Recent turmoil in the Chinese equity markets will suppress even Chinese IPOs.

Summary and implications

The amount of economic, geopolitical and structural changes, disruptions and uncertainties has suppressed chemical industry share prices, M&A activity and debt and equity financing. The only exception has been Asian IPOs. None of these areas of financial activity are at trough levels, but they are clearly subdued versus the more robust activity in recent years. These trends will continue through the rest of 2022 and beyond. If there is any alternative scenario, it is a more pronounced downside case where economic developments and geopolitical events are worse than current expectations.

Chemical industry leaders will be under a great deal of pressure as they deal with the dramatic and long list of geopolitical, economic and structural disruptions. The key will be the ability to be resilient, to pivot quickly as conditions change, and to focus on maintaining and building competitive advantages.

This is still a good time to sell specialty chemical businesses that are non-core and result in an improved corporate portfolio or additional cash. Buyers will have to find targets that are synergistic and strategically important and where inefficiencies in the M&A market cause valuations to be lower than the fair market value of the business. It will also be important to find creative ways to finance acquisitions given the absence of attractive debt financing. ■

Peter Young is CEO of Young & Partners, an international investment banking and strategy consulting firm that focuses on the chemical and life science industries. The firm executes corporate and financial strategy projects, M&A, private placements of debt and equity, and financial restructuring. Young & Partners has served a global client base of companies in Europe, North America, Latin America and Asia for the last 27 years.
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